



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
Attn: Mandatory Review, MC 4920
1100 Commerce Street
Dallas, TX 75242

501.15-00

TAX EXEMPT AND
GOVERNMENT
ENTITIES DIVISION

Date: June 17, 2010

Release Number: 201039040

Release Date: 10/1/10

LEGEND

ORG = Organization name XX = Date

Address = address

Employer Identification Number:

Person to Contact / ID Number:

Contact Numbers:

Voice:

Fax:

ORG

ADDRESS

CERTIFIED MAIL – RETURN RECEIPT REQUESTED

Dear

This is a final adverse determination letter with regard to your status under section 501(c)(15) of the Internal Revenue Code.

In a determination letter dated June 17, 19XX, you were held to be exempt from Federal income tax under section 501(c)(15) of the Internal Revenue Code (the Code).

You do not qualify as a tax-exempt small insurance company because your premium income does not exceed 50% of your gross receipts for 20XX. Therefore, we have determined you have not operated in accordance with the provisions of section 501(c)(15) of the Code. Accordingly, your exemption from Federal income tax is revoked effective January 1, 20XX.

We previously provided you a report of examination explaining why we believe revocation of your exempt status is necessary. At that time, we informed you of your right to contact the Taxpayer Advocate, as well as your appeal rights. On March 3, 20XX, you signed Form 6018-A, Consent to Proposed Action, agreeing to the revocation of your exempt status under section 501(c)(15) of the Code.

You have filed taxable return, Form 1120-PC, ORG Income Tax Return, for the year ended December 31, 20XX, with us. For future periods, you are required to file an income tax return with the appropriate service center as indicated in the instructions for the return.

You have the right to contact the Office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal

Appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free, 1-877-777-4778, and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please contact the person whose name and telephone number are shown at the beginning of this letter.

Sincerely,

Nanette M. Downing
Director, EO Examinations

Encl: Form 6018-A

Internal Revenue Service

Department of the Treasury

TE/GE Division

450 Golden Gate Avenue, Stop 7-4-01

San Francisco, CA 94102-3412

Date: February 24, 2010

ORG

ADDRESS

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

CERTIFIED MAIL - RETURN RECEIPT REQUESTED

Dear

We have enclosed a copy of our report of examination explaining why we believe revocation of your organization's exempt status is necessary.

If you do not agree with our position you may appeal your case. The enclosed Publication 3498, *The Examination Process*, explains how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

If you request a conference, we will forward your written statement of protest to the Appeals Office and they will contact you. For your convenience, an envelope is enclosed.

If you and Appeals do not agree on some or all of the issues after your Appeals conference, or if you do not request an Appeals conference, you may file suit in United States Tax Court, the United States Court of Federal Claims, or United States District Court, after satisfying procedural and jurisdictional requirements as described in Publication 3498.

You may also request that we refer this matter for technical advice as explained in Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues*. If a determination letter is issued to you based on technical advice, no further administrative appeal is available to you within the IRS on the issue that was the subject of the technical advice.

If you accept our findings, please sign and return the enclosed Form 6018, *Consent to Proposed Adverse Action*. We will then send you a final letter revoking your exempt status. If we do not hear from you within 30 days from the date of this letter, we will process your case on the basis of the recommendations shown in the report of examination and this letter will become final. In that event, you will be required to file Federal income tax returns for the tax period(s) shown above. File these returns with the Ogden Service Center within 60 days from the date of this letter, unless a request for an extension of time is granted. File returns for later tax years with the appropriate service center indicated in the instructions for those returns.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Nanette M. Downing
Acting Director, EO Examinations

Enclosures:
Publication 892
Publication 3498
Form 6018
Report of Examination
Envelope

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit REVISED
Name of taxpayer ORG	Tax Identification Number	Year/Period ended 12/31/20XX

LEGEND

ORG = Organization name ORG-1 = 1st ORG XX = Date City = city Country = country
 President = president DIR-1 = 1st DIR CO-1, CO-2 & CO-3 = 1st, 2nd, & 3rd COMPANIES

ISSUE:

Whether ORG (formerly, ORG-1), a controlled foreign corporation, meets the new gross receipts requirements for tax-exempt status, under IRC 501(c)(15), as described in the Pension Funding Equity Act of 20XX?

FACTS:

ORG (hereinafter "ORG") was initially incorporated on December 15, 19XX, in the Country and Country, under the name ORG-1, under the provisions of Part IV of the Companies Ordinance 19XX. The primary purpose for which the corporation was formed is to provide and negotiate insurance services consistent with any license granted in the respect under the laws of the Country and Country.

The corporation is licensed to engage in the insurance business by the , Country and Country. The liability of members is limited. CO-1 acts as the Corporation's insurance manager and is responsible for maintaining the principal office of the Corporation in the Country and Country. The corporation is authorized to issue shares of \$ per share. The corporation actually issued shares. President, a United States citizen and resident, owns all of the common shares and is the sole shareholder and President of the corporation.

On March 6, 19XX, a Certificate of Name Change was filed by President, with the Registrar of Companies, changing the name of the corporation to its current name, ORG.

An election was filed under Internal Revenue Code section 953(d) to be treated as a domestic corporation for United States tax purposes. The election was approved by the Service and commenced on December 28, 19XX.

Internal Revenue Service records reveal that ORG was granted exemption as a small insurance company described in section 501(c)(15) of the Internal Revenue Code on June 17, 19XX. The exemption was effective as of January 1, 19XX, for all tax years when net written premiums (or, if greater, direct written premiums) do not exceed \$.

ORG is required to file annual information return, Form 990. The Form 990 return filed for the year ended December 31, 20XX, was examined by TE/GE, City Post of Duty. During the initial inspection of the Form 990 for 20XX, it was noted that ORG reported being exempt under IRC 501(c)(15) on line J in the heading of the return.

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Since the passage of the Pension Funding Equity Act of 20XX, ORG filed Form 990 returns for tax years ended December 31, 20XX, December 31, 20XX, and December 31, 20XX. On its Form 990 return filed for the year ended December 31, 20XX, ORG reported the following sources of income:

20XX

Gifts, Grants and Contributions	\$ -0-
Program Service Revenue	
Membership dues/assessments	--
Interest on savings	
Dividends and interest	
Other investment income	
Gain of Sale of Assets	
Other income	--
Totals	\$ --

During the examination of the 20XX Form 990, a copy of the corporation's Form 1024, Application for Recognition of Exemption Under Section 501(a), was reviewed. The filed included a copy of the Retrocessional Excess of Loss Reinsurance Treaty entered into between ORG and CO-2. ("CO-2"). ORG has not entered into any other reinsurance treaties. According to the Form 1023 application, the primary activity of ORG is determined to be as follows:

To act as a retrocessional reinsurer of all policies related to asbestos liability insurance coverage, reinsured by CO-2. ("CO-2"), and which are originally issued by CO-3 ("CO-3"). CO-3 is a City licensed insurance company and is authorized to write insurance in all 50 states for contractors, consultants, and other entities involved in environmental remediation projects. First established in 19XX, CO-3 insures over 700 entities throughout the United States, and is rated "A" (Excellent) by A.M. Best Company.

The corporation acts as a retrocessional reinsurer of CO-2. In such capacity, as is customary in the reinsurance industry, the corporation follows the fortunes of its reinsured with respect to the administration and payment of claims. CO-2, as the reinsurer of CO-3, relies on CO-3 for marketing of policies to the asbestos/environmental remediation industry and brokers representing insured's in this industry. CO-3 is also responsible for claims adjustment activities and maintains its own claim department. Claims submitted to ORG are reviewed by the President to ensure that the line of coverage is included in the business reinsured under the treaty and not excluded under any other provisions of the treaty.

ORG owns less than 1 percent of the stock of CO-2 by virtue of a capital contribution upon the formation of ORG. President, President, also owns 3.6 percent of the stock of CO-2. The other director, presumably DIR-1, wife, owns 1.4 percent of the CO-2 stock. None of the directors own an interest in CO-3.

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CO-3 insures general and pollution liability for those engaged in environmental remediation projects. With respect to each policy retrocessionally reinsured by ORG, the corporation reinsures CO-2 for \$ excess of \$ in the layer of \$ million excess \$ million each policy.

During the 20XX tax year, ORG did not receive any net written premiums or reinsurance premiums from insurance or reinsurance business. On the 20XX Form 990 return, ORG reported gross receipts of \$ and total revenue of \$. The total revenue amount was used to determine the eligibility to file Form 990 for the 20XX tax year. The difference between the amounts resulted from the reporting of the sale of assets. The gross receipts amount includes the gross proceeds received from the sale of assets, while the total revenue figure includes only the net gain after offsetting losses from the sale of assets.

ORG's revenue consisted of a drawdown of reserves in the amount of \$; gross investment income of \$; and net gains from the sale of assets of \$.

ORG's total revenue reported on line 12 of the 20XX Form 990 is less than the \$ limitation imposed by the Pension Funding Equity Act of 2004. The return did not include an adequate schedule showing the reconciliation of the capital gain net income. Therefore, the examining agent was unable to confirm whether gross receipts were actually less than the \$ imposed under Internal Revenue Bulletin Notice 2006-42. However, in response to Information Document Request #3, Question 4, President provided the following statement:

The information requested was provided in Attachment 21 to IDR #1. Please note that in determining gross receipts, only "the gain (but not the entire amount realized) from the sale or exchange of capital assets" is included [see Notice 20XX-42, Section 3]

The documents provided in Attachment 21 reflected the individual sales transactions, however, the statements reported only the proceeds from such sales and not the cost basis of the securities sold. Thus, the examining agent could not confirm the accuracy of the above statement made by President.

Assuming ORG's gross receipts for the 20XX tax year are, in fact, less than the \$ gross receipts limitation described in Notice 20XX-42, then the premiums earned by ORG must constitute "more than % of such gross receipts. ORG did not receive any net written premiums or reinsurance premiums during the year. ORG reported \$ as "Program Service Revenue" on line 2, Part I, of the 20XX Form 990. This amount was not derived from net written premiums or reinsurance premiums received by ORG. The amount actually represented a reduction of reserves for "Incurred But Not Reported Losses," previously reported as a liability on ORG's Balance Sheet. The Program Service Revenue was computed by taking the difference between the beginning and ending balances of the IBNR reserve account reported as a liability on line 65, Part IV, of the 20XX Form 990. The reserves of \$ are excluded from the "gross receipts" calculation described in Notice 20XX-42 because the amount was not derived from net written or reinsurance premiums. Therefore, ORG's premium income did not exceed % of its 20XX gross receipts.

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ORG does not qualify for tax-exempt status under IRC 501(c)(15), for the 20XX tax year, because it failed to meet the new gross receipts requirements for tax-exempt status as described in the Pension Funding Equity Act of 20XX and Notice 20XX-42. See Attachment 1 for gross receipts computation prepared by the examining agent.

LAW:

PRIOR LAW

I.R.C. § 501 provides that certain entities are exempt from taxation. Included in these entities are “[i]nsurance companies or associations other than life (including interinsurers and reciprocal underwriters) if the net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed \$.” I.R.C. § 501(c)(15)(A). If an entity is a part of a consolidated group, all net written premiums (or direct written premiums) of the members of the group are aggregated to determine whether the insurance company meets the requirements of I.R.C.

§ 501(c)(15)(A).

The prior law was effective for tax years beginning after December 31, 1986, through December 31, 20XX, the effective date of the Pension Funding Equity Act of 20XX.¹

CURRENT LAW

For tax years beginning after December 21, 20XX, an organization must meet the following two-part test to qualify for exemption under IRC 501(c)(15):²

1. Gross receipts for the year may not exceed \$ and
2. Premiums must be more than 50% of the organization’s total gross receipts.

Mutual insurance companies must meet either the above test, or the following alternative test:

1. Gross receipts for the year may not exceed \$ and
2. Premiums must be more than 35% of the organization’s total gross receipts.

Amounts received by all members of the insurance company’s controlled group [as defined in section 501(c)(15)(c)] are taken into account for purposes of these tests.

For purposes of section 501(c)(15)(A), gross receipts includes the following sources:

A. Premiums (including deposits and assessments) without reduction for return premiums or premiums paid for reinsurance;

¹ Prior to 1986, the direct or net written premium ceiling was limited to \$. The Tax Reform Act of 1986 increased the direct or net written premium ceiling to \$ per year.

² Notice 20XX-42, I.R.B. 20XX-19, April 24, 20XX.

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B. Items described in section 834(b) [gross investment income of a non-life insurance company] and

C. Other items that are properly included in the taxpayer's gross income under subchapter B of chapter 1, subtitle A, of the Code.

The alternative test for a mutual insurance company does not apply if an employee of the company, or a member of the employee's family [as defined in IRC section 2032A(e)(2)] is an employee of another company exempt from tax (or would be exempt) under IRC section 501(c)(15).

If an organization is in a receivership, liquidation, or similar proceeding under the supervision of a state court on April 1, 20XX, the new law applies to taxable years beginning after the date such proceeding ends or December 31, 20XX, whichever is earlier.

GOVERNMENT'S POSITION:

Internal Revenue Code section 501(c)(15) originally referred only to certain mutual insurance companies or associations other than life or marine. The Tax Reform Act of 1986 ("TRA-86") eliminated the distinction between small mutual insurance companies and other small insurance companies and extended exemption under IRC 501(c)(15) to all eligible small insurance companies, whether stock or mutual.

TRA 86 also changed the nature of the ceiling amount for tax exemption from certain gross receipts to direct or net written premiums. The ceiling amount was changed from \$ to \$. Therefore, under TRA 84, to qualify for exemption as a small insurance company, the direct or net written premiums received by an organization could not exceed \$ for a taxable year.

The requirements established under TRA 86 posed serious problems for the Service, because the requirements did not place any limitation of the amount of investment income small insurance companies could earn. Many taxpayers and tax professionals took advantage of the tax-exempt treatment allowed to small insurance companies by contributing highly appreciated income producing assets to the tax-exempt organizations. The assets produced substantial investment income that was not taxed due to the tax-exempt status of the small insurance companies.

Congress intended to curb this loophole in the law by including language in Section 206 of the Pension Funding Act of 20XX, which, once again, changed the requirements for tax-exempt status for Small Property and Casualty Insurance Companies.

On April 10, 20XX, President signed H.R. 3108, the Pension Funding Equity Act of 20XX, P.L. 108-218. One purpose of the legislation was to tighten the rules for property and casualty insurance companies to qualify as tax-exempt under section 501(c)(15) of the Code, or to elect to be taxed only on their investment income. The bill contained the following comments from the Conference Report:

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The limitation to mutual companies and the limitation on employees are intended to address the conferees' concern about the inappropriate use of tax-exempt insurance companies to shelter investment income, including in the case of companies with gross receipts under \$. It is intended that the provision not permit the use of small companies with common owners or employees to shelter investment income for the benefit of such owners or employees.

The new legislation amended IRC 501(c)(15) for tax years beginning after December 31, 20XX. The new law replaced the "written premiums test" with a "gross receipts and percentage of premiums test."

The new law placed an overall limitation on the amount of gross receipts small insurance companies could earn for each taxable year. Thus, for years beginning after December 31, 20XX, small insurance companies can not have gross receipts in excess of \$ to qualify for tax-exempt status under IRC 501(c)(15). In addition, of its total gross receipts, more than 50% must be derived from premium income.

The facts present in this case clearly demonstrate that ORG does not meet the new requirements for tax-exempt status under IRC 501(c)(15), in 20XX, because its net written premiums or premiums from reinsurance is less than 50% of its gross receipts for the year. In fact, ORG did not earn any net written premiums or reinsurance premiums during the 20XX tax year. During the 20XX tax year, ORG's primary sources of income are from investments and a reduction of reserves for IBNR. During the audit, gross receipts were re-computed to comply with the definition of "gross receipts" that is described in Notice 20XX-42. Based on the audit, ORG's gross receipts for 20XX are as follows:

20XX

Net Premiums Written	\$ --
Interest on temporary savings	
Dividends and interest from securities	
Other investment income	
Gain on sale of assets	
Other income	
Gross Receipts	\$

Do Gross Receipts exceed \$ limitation? NO

50% of Gross Receipts	
Net Premiums Written	-0-

Do Premiums exceed 50% Of Gross Receipts? NO

Does Org meet the Gross Receipts Test? NO

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Does Org Qualify for exemption Under IRC 501(c)(15)?

N0

Filing Requirement

1120-PC

NOTE: As a stock corporation, the alternative gross receipts test (\$/35%) is NOT available to ORG. Such alternative test is available to mutual insurance companies only.

The principal gross receipts test consists of two parts. The corporation must satisfy both parts of the \$/50% gross receipts test. In this case, ORG does meet part-one of the test because its gross receipts do not exceed the \$ gross receipts limitation permitted for small insurance companies. However, ORG does not satisfy part-two of the gross receipts test because its premium income is not more 50% of gross receipts for 20XX. ORG must satisfy both parts of the \$/50% gross receipts test in order to meet the new requirements for tax-exempt status under section 501(c)(15) of the Code. If ORG fails to meet either component of the two part test, then it fails to qualify for exemption as a small insurance company.

Based on the above analysis, it is determined that ORG was properly recognized as a tax-exempt small insurance company for years prior to December 31, 20XX. However, due to the change in law, the corporation no longer qualifies for tax-exempt status for the tax year ended December 31, 20XX, because it fails to comply with the \$/50% gross receipts test imposed by the Pension Fund Equity Act of 20XX.

As such, it is recommended that ORG's tax-exempt status under IRC 501(c)(15) be revoked, effective January 1, 20XX.

TAXPAYER'S POSITION:

After receiving the initial 30 Day Letter dated January 13, 20XX, a formal protest was filed by President, President and sole shareholder, dated February 12, 20XX. The protest was received by the IRS, TE/GE Division on February 18, 20XX. In the protest, President disagreed with the Service's characterization of the \$ Program Service Revenue as "unearned premium" income. President stated that the amount represented a "drawdown in reserves for IBNR," and is not unearned premiums. President requested that the initial report Form 886-A be revised to reflect this correction, and if the report is revised, ORG is agreeable to executing Form 6018-A, for the proposed revocation action. The revocation would cover the 20XX tax year only, since ORG did not claim to be tax-exempt for the subsequent tax years ending December 31, 20XX, and December 31, 20XX. ORG filed Form 1120-PC returns as a taxable property and casualty insurance company for both years. If the Service does not agree to revise the initial report, then the taxpayer wants the issue sent to Appeals.

CONCLUSION:

A. ORG is an insurance company pursuant to Subchapter L of the Code for the taxable year 20XX.

B. Although ORG is an insurance company pursuant to Subchapter L of the Code, it does not qualify as a tax-exempt small insurance company because its premium income does not exceed 50% of its gross

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receipts for 20XX, as described in Internal Revenue Bulletin, Notice 20XX-42, required of entities that qualify for exemption under IRC 501(c)(15) of the Internal Revenue Code.

C. Therefore, revocation of ORG's tax-exempt under IRC 501(c)(15) is proposed, effective January 1, 20XX.

D. ORG is required to file an income tax return for calendar year ended December 31, 20XX.

GROSS RECEIPT CALCULATION FOR THE TAX YEAR ENDED DECEMBER 31, 20XX, IN COMPLIANCE WITH INTERNAL REVENUE BULLETIN, NOTICE 20XX-42, DATED, MAY 8, 20XX.

Net Premiums Written	-0-
Interest on temporary savings	
Dividends and interest from securities	
Other investment incomes	
Gain on sale of assets	
Other income	<u>-0-</u>
Gross Receipts	

1. GROSS RECEIPTS FOR THE TAX YEAR DID NOT EXCEED THE \$ LIMITATION.

PREMIUM INCOME TEST:

NET PREMIUMS WRITTEN	<u>-0-</u>	= 00.00%
GROSS RECEIPTS		

2. EARNED PREMIUMS ARE NOT "MORE THAN 50%" OF GROSS RECEIPTS.

CONCLUSION:

ORG DOES NOT MEET THE GROSS RECEIPTS TEST DESCRIBED IN NOTICE 2006-42 AND THE PENSION PROTECTION EQUITY ACT OF 20XX. ORG IS NOT PERMITTED TO FILE FORM 990 FOR THE TAX YEAR ENDED DECEMBER 31, 20XX, AS A TAX-EXEMPT SMALL INSURANCE COMPANY DESCRIBED IN SECTION 501(c)(15) OF THE INTERNAL REVENUE CODE, BECAUSE IT FAILS TO QUALIFY FOR TAX-EXEMPT STATUS.

ATTACHMENT #1